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Piecemeal Approach to Current Value Accounting: Evolutionary Abandonment of The Traditional Accounting Model?

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The Piecemeal Approach to Current Value Accounting

Evolutionary Abandonment of The Traditional Accounting Model?

By Roland L. Madison

Is 1984 to be the year of several revolutionary developments in our traditional accounting model? Many scholars of accounting history would, no doubt, accept this as a possibility.

During the past decade, many significant changes, albeit somewhat subtle at times, have been made in the traditional financial reporting model being used in the United States. This article does not purport to explore and discuss all of the potential ramifications the title may imply. It does, however, attempt to make the financial community aware of the significant changes in the traditional model that have developed over the past decade, and even more important is an awareness of the potentially radical change in our accounting model that may be on the horizon. The significant change is primarily a result of the recently issued *Invitation to Comment* (FASB, 1983) that is related to Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices" (FASB, 1979) and the newly proposed *Statement of Financial Accounting Concepts*, "Recognition and Measurement in Financial Statements of Business Enterprises," (FASB, 1983). First, however, it is appropriate to examine the events that set the stage for these potentially major changes in the traditional reporting model.

Generally Accepted Accounting Principles: A Consensus

A definitive statement is necessary before exploring the changes that are pertinent to our accounting model. Most accounting scholars would concur that *generally accepted accounting principles* (GAAP) includes a set of conventions, principles, and procedural rules adopted by consensus or by promulgation from professional organizations or by government edict at a point in time (APB Statement No. 4, 1970). Furthermore, this consensus of opinion changes in response to changing economic, social, political conditions, development of new knowledge, advancement of technology, and demands made by users for more relevant financial information (APB Statement, No. 4). Accordingly, it holds that generally accepted accounting principles change as our business environment and needs for information change.

Posture for Overall Change Becomes Evident

An obvious presumption underlying the preceding comments is that the consensus of what is deemed relevant information [e.g., that which has the ability to make a difference (improvement?)] in the decision-making process according to the Statement of Financial Accounting Concepts No. 2, (FASB, 1980) has, in fact, changed — and the desire for the change has "substantial authoritative support."

Given these thoughts, the next part of this discussion presents several of the early proposals to alter dramatically the transactions-based historical cost model to a current- or fair-value model and then, lacking success, began an evolutionary process toward this end.

As to the terms "current-value" and "fair-value," no lengthy attempt is made to distinguish between them. It is suffice to say that often their valuations, and thus their semantic meanings, are equivalent enough to use the terms concurrently, if not interchangeably. Thus, this point of debate merits no further elaboration within the scope of this article.

Bypassing the early proposal of Sweeney (*Stabilized Accounting, 1936*), we had several relatively "modern" proposals put forth to greatly modify or to even discard the traditional accounting model. The American Institute of Certified Public Accountants once sponsored a research study (*Accounting Research Study No. 6*, "Reporting the Financial Effects of Price-Level Changes," 1963) that suggested various indexing approaches to provide supplementary material to the traditional historical-cost based primary financial statements. A few companies experimented with this approach on a voluntary basis in the 1960s but discarded it.

The American Accounting Association (AAA) followed shortly thereafter with *A Statement of Basic Accounting Theory* (ASOBAT, 1966) which called for multi-column and multi-valued financial statements (historical- and current- cost). This was quite a change from the AAA sponsored monograph by Perry Mason (1956) that called for a general price-level form of financial statements versus the current-value approach suggested in ASOBAT.

In brief, none of the preceding proposals obtained "substantial authoritative support" via a consensus toward a change in the basic accounting model.

The Development of an Evolutionary Approach

Most of the proposals were rejected by the business community and by the accounting profession as being too radical a departure from the time-tested transactions-based historical cost model. Thus, it appears to this writer that the authoritative committees of the accounting profession, greatly stimulated by the public sector (SEC) and through litigation, began what may be described as a piecemeal evolutionary approach to adopt a current- or fair-value based accounting model.

It is debatable when this change in methodology (from wholesale revision to piecemeal adoption) and emphasis on current- and fair-value accounting began, but a reasonable approximation would be the early 1970s. As noted in the preceding paragraph, pressure from the SEC, criticisms of the Accounting Principles Board, and major cases of litigation against accountants made the profession very vulnerable for changes that were presented as improvements of the reporting model (see, for example, *The Woman CPA*, January 1982 issue, pp. 17-20).

Early proposals began an evolutionary process toward current-value accounting.

As a point of clarification, the authoritative pronouncements mentioned in this section are generally quite technical and may be subject to an extended analytical discussion. The purpose of their identification is neither to explain their mechanics nor to debate their points of merit. No doubt many would agree that some of the changes do have a legitimate basis — conceptually and pragmatically. Instead, its purpose is to illustrate to the reader that a concentrated evolutionary effort was being made in some areas of financial reporting to develop a current- or fair-value oriented model with a corresponding departure from the traditional financial reporting model (as described primarily in APB Statement No. 4) which has been accepted by consensus as providing sufficient information for decision-makers.

In APB Opinion 18 (1971), the Board specified when a departure was preferred from the cost method of accounting for investments in common stock to the equity method of income recognition. In the latter approach the investor adjusts the carrying amount of the investment account to recognize a proportionate share of the earnings or losses of the investee prior to their distribution to the investor entity. This is a departure from the legal (cost) approach.

While the Board believed the market value method provided the best presentation of investments in some situations, it concluded that further study was necessary before the market value method was extended beyond current practice (APB Opinion 18, para. 9).

The implication given by the Board in its discussion was that the equity method was representative of the investor's degree of fair value and control over the investee and further movement toward the market value approach was not presently feasible.

Later that year, the Board issued APB Opinion No. 21 which required an imputation of interest on various receivables and payables. While the opinion appeared to focus on the proper determination and disclosure of interest charges, its effect upon asset valuation unfortunately did not demand equal attention (perhaps due to "bottom line" focus on income).

The asset valuation was essentially subject to either the market value of the instrument or the fair value of the asset if such was readily determinable. If it was not, then the appropriate "market rate" of interest was applied to the face of the debt instrument thereby backing into the "market value" of the asset. Obviously if the former item was not objectively determinable (the interest rate), then the resultant market value of the asset was also distorted.

Selected current replacement costs may find their way into the financial statements.

The push toward current- or fair-value accounting continued the next year (1972) when the Board extended and modified the applicability of ARB No. 43 (Chapter 13B) to measure compensatory stock plans issued to employees at the quoted market price of the stock (APB Opinion 25, "Accounting for Stock Issued to Employees," 1972). The accrual of such market value as a cost of executive compensation before the stock is issued is an acceleration of the realization process using market value as a measure of the executive's cost (and surrogate for market value) to the entity.

The final definitive push by the Board before their transition of the standards setting function to the Financial Accounting Standards Board was APB Opinion No. 29 ("Accounting for Nonmonetary Transactions"). In brief:

> *The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions (APB No. 29, para. 18).*

The Board also discussed various manners of determining "fair value," (para. 25) and appropriate alternative treatments when that could not be done.

FASB Continues the Pattern — And Accelerates

While SFAS No. 12 (lower of cost or market for marketable equity securities) and a number of other statements issued by the Board could be discussed in the evolutionary process, the most striking changes have been Statements 8 and 52, dealing with foreign currency translation, Statement 33 that considers financial reporting and changing prices and Statement 70 which amends certain price-level disclosures required by SFAS 33 when foreign currency translation is involved.

Statement Nos. 8 and 52 have a direct impact upon our basic financial reporting model for those entities that are active internationally. Translation gains and losses (translation adjustments) resulting from converting foreign entities' statements to the U.S. reporting model were initially passed through the income statement (SFAS No. 8) although no transfer of resources had occurred at the statement date.

This caused great fluctuations in reporting earnings although no real increase or loss in the value of the asset or liability had occurred. SFAS No. 52 excluded these exchange rate fluctuation adjustments that surfaced at consolidation (statement conversion) from income determination and required these items (both gains and losses) to be accumulated as a separate part of consolidated equity until the liquidation and subsequent realization of the investment in the foregin entity occurred.

However, SFAS No. 70 required that unhedged transaction gains and losses (denominated in the nonfunctional currency) reflect current market rate changes and be included in net income. Thus a portion of the current-value (exchange rate) remained as an element affecting the primary financial statements of the basic model.

The Board continued their posture in the evolutionary development of a current-value model when they incorporated the market-value fluctuations of pension plan assets in the measurement of current pension costs and the presentation of the net pension obligation on the balance sheet (FASB, November, 1982). One disenchanted CFO said:

> *The FASB's pronouncements over recent years reveal a clear movement toward using changes in balance sheet values to determine periodic earnings (Buxbaum, 1983).*

However, as stated initially in this article, the Board issued two documents late last year that may greatly accelerate the piecemeal adoption of a current value mode. These documents demand close attention.

SFAS 33: The 'Great Experiment' Fails — But Is It Dead?

The first document was identified as the *Invitation to Comment* on *Supplementary Disclosures about the Effects of Changing Prices* (FASB December 27, 1983). This *Invitation to Comment,* which relates to *FASB Statement 33* (1979), takes on more relevance to the gradual adoption of a predominately current-value model, when it is coupled with certain groundbreaking avenues opened by the second document, previously identified as the proposed *Statement of Financial Accounting Concepts* (Exposure Draft) titled "Recognition and Measurement in Financial Statements of Business Enterprises" (FASB, December 30, 1983).

The overall constructive style and thrust of the *Invitation to Comment* virtually begs for some positive statement about the utility of the current-value and constant-dollar disclosures required by FASB Statement 33 that may somehow be salvaged by the Board. Conjecture, with the wisdom and logic provided by hindsight of the piecemeal moves that have occurred over the past decade, may suggest that selected current replacement costs and holding gains and losses extracted from Statement 33 may find their way into the primary financial statements through the proposed "comprehensive income" vehicle being developed by the Board.

Certainly for the present, this potential development must be halted. It simply defies consistency with the conceptual framework project, whose integrity must be protected if we are to maintain the standard-setting function in the private sector.

As noted in the *Invitation to Comment* by the Board, research projects by Berliner (1983) and Norby (1983) showed either "limited use of Statement 33 data" or "little systematic use" by financial analysts and portfolio managers. Another widely publicized study by Beaver and Landsman (FASB, 1983) strongly tends to refute the possibility that a more efficient allocation of scarce resources would result from Statement 33 data. They found that security prices from 1979 through 1981 were more highly correlated with historical cost data and earnings than with either constant-dollar or current-cost data. Another study covering the same time period was directed to senior financial management who are the preparers of Statement 33 data. This group, which the Board said would be a major user and beneficiary of such information (SFAC No. 1, 1978), virtually rejected any utility derived from Statement 33 data (Madison and Radig, 1983).

Given an impartial reading, the findings of these studies should preclude the integration of any current-value attributes as used in Statement 33 from becoming an element of income determination in our financial reporting model.

A dramatic change may be expected in the traditional reporting model.

The business community, however, should recall that this Statement was issued by the Board under direct pressure from the SEC when former Chairman Williams told many accountants (Denver, August, 1978) to look at inflation accounting models of other countries and then to move quickly. The SEC used Accounting Series Release (ASR) No. 190 (requiring current replacement cost value for inventories and plant assets) and Reserve Recognition Accounting (RRA) for the oil and gas industry as a stimulus (a threat in pragmatic terms) to elicit action from the private sector through the FASB.

Thus, given the historical development of Statement 33 combined with the Concepts Statement (Exposure Draft) on recognition and measurement, it is still possible that the Board plans to introduce some form of current-value measurement when reporting the results of operations of a business entity.

In the Concepts Statement (ED), the Board proposes to portray the results of operations in a combined "Statement of Earnings and Comprehensive Income." This vehicle may be reduced to its two components as follows: the first portion is an "earnings statement" that is based primarily upon historical cost and exchange transactions while selectively using the four exception measurement attributes of replacement cost, current market value, net realizable value and present value in certain instances when they are deemed more relevant or are a more reliable measurement attribute. The Board does not stop here. The "cumulative effect of certain accounting changes" which are presently shown as catch-up adjustments on the traditional income statement and changes in the market values of investments in noncurrent marketable equity securities plus foreign currency translation adjustments that are presently displayed as direct changes in owner's equity on the balance sheet will be components of the second portion of operations labeled as "comprehensive income." This term is defined as a broad measure of the effects of transactions and *other events* on an entity, comprising all recognized changes in equity during a period except owner investments and distributions to owners. (SFAC Exposure Draft, p. 13).

Exactly what is this strange creature proposed by the Board? It seems to be a cross-breeding of the current operating performance income statement, with the "earnings" portion based primarily upon realized exchange transactions, followed by elements of the "all-inclusive model" of income reporting, and expropriating unrealized value changes from the equity section of the balance sheet.

In the Concepts Statement, the Board does not preclude the recognition of undefined market value increments that exceed cost based exchange-transactions and other price changes as element of comprehensive income. Furthermore, the Board states that while the "earnings" portion is nearly equivalent to our concept of realized "income," nothing precludes the evolutionary change of financial items being moved from an element of comprehensive income, which is predominately comprised of unrealized market and price changes, into the more traditional realized "earnings" portion of the operations statement.

Summary and Conclusion

Empirical evidence discussed in recent articles suggests that the information required by SFAS 33 is not consistent with the primary objective of financial reporting; that is, in assisting the decision-maker "in assessing the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" *(Statement of Financial Accounting Concepts No. 1, 1978, pp. 17-18).* Empirical research also questions the degree to which Statement No. 33 has the requisite qualitative characteristics of "relevance and reliability" that financial information must possess to make it useful (see *Statement of Financial Accounting Concepts No. 2, 1980*).

Given the piecemeal evolutionary progress to date coupled with the supposedly "experimental" status of SFAS No. 33 in providing supplemental information to the primary financial statements that is supported by SEC stimulus, and perhaps with the recognition and measurement exposure draft recently issued, we may expect a dramatic change in the traditional reporting model.

All interested parties in the financial community must become aware of these developments and proposals for rather dramatic change that may be forthcoming. To maintain the credibility for retention of the accounting standard setting function in the private sector, we must see that any proposal is consistent with the conceptual framework project.

Such proposals, regardless of their approach — piecemeal or otherwise — must be evaluated in terms of the following question. Does the change substantively demonstrate a significantly material improvement in the decision-making usefulness of our financial reporting model? Some outspoken practitioners feel the Board offers nothing to meet this basic justification for change (Gerboth, 1984). However, our evaluation of the Board's proposals, whether they are concurrence, complete disagreement, or qualifications, must be presented to the Board in an informed manner.

Evolution, as a natural reaction to meet a definite need, is acceptable and should be expected. However, the potentially significant modifications that are proposed for a powerful and time-tested model should be challenged. It is hoped that this discussion will make our colleagues in business and academia aware of the potential for change and improvement that we may help develop. Remember that generally accepted accounting principles are determined by consensus, and that the business community and its accounting firms contribute a major influence in the determination of that consensus.

A uniform opinion by these groups, in any posture, may require the governmental pressures being placed upon the Board to be carefully evaluated and will no doubt influence the future of our financial reporting model. Ω

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See supplement on page 33.

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SUBJECT

Current Value Accounting Supplement

"The Piecemeal Approach to Current Value Accounting" article would not be complete without the inclusion of three strong recommendations recently made by Donald C. Haley, Vice President-Control, Standard Oil of Ohio (American Accounting Association Annual Meeting, Toronto, August 18, 1984). These recommendations were made in the presence of FASB Vice Chairman Sprouse and Dr. Arthur R. Wyatt, presently the Managing Director-Accounting Principles for Arthur Andersen and Company and soon to be an FASB member (effective January 1, 1985). Mr. Haley's recommendations were as follows:

1. The FASB must re-commit itself to the completion of the Conceptual Framework Project; review and *probably revise* (emphasis added by speaker) the proposed SFAC "Recognition and Measurement in Financial Statements of Business Enterprises."

What direction should this revision take? His second recommendation leaves us with little doubt.

2. The FASB should pull back from its predictive value thrust to one of "full and fair disclosure" of reporting the actual results (of operations).

Mr. Haley used the phrase "predictive value" in a context that viewed "current value" per SFAS No. 33 as being a form of predictive values having limited utility. His final recommendation and a brief discussion with Haley reinforce the preceding comment about Statement 33.

3. The FASB should give greater consideration to the value of input from the preparers of financial statements and reports.

Messrs. Sprouse and Wyatt declined to take substantive issue with Mr. Haley's recommendations — perhaps meaning constructive agreement? This writer openly concurs with Mr. Haley without qualification.

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